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BALTIMORE COUNTY
MARYLAND

FRED HOMAN
Administrative Officer

JAMES T. SMITH, JR.
County Executive

November 26, 2007

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Baltimore County Auditors Office

The Honorable S. G. Samuel Moxley
Chairman
Baltimore County Counil
400 Washington Avenue
Towson, MD 21204

Dear Chairman Moxley:

On August 24, 2007, commercial paper issued by Mainsail II LLC and owned by Baltimore County with a par value of $21.3 million failed to pay off at maturity. The County purchased the commercial paper from Merrill Lynch on July 31, 2007. At the time of the purchase, the commercial paper was rated A-1+ by Standard & Poor's (S&P) and P-1 by Moody's Investors Service (Moody's), the highest short-term ratings for commercial paper. The purchase of the Mainsail commercial paper was consistent with the County's Investment Policy, adopted by County Council Resolution No. 44-95, and a permissible investment of County funds under State law (Section 6-222 of the State Finance and Procurement of the Annotated Code of Maryland; Section 22 of Article 95 of the Annotated Code of Maryland).

BACKGROUND

The purchase of commercial paper is permitted under Maryland law. The Annotated Code of Maryland authorizes the governing body of each county to invest in commercial paper that has received the highest letter and numerical rating by at least two nationally recognized statistical rating organizations as designated by the United States Securities and Exchange Commission, provided that such commercial paper does not exceed 10% of the total portfolio. Maryland law was changed October 1, 2006 to increase commercial paper exposure from 5% to 10% and to require that the commercial paper investment be rated by two rating agencies, rather than one as previously required. This recent legislation expanded the ability of counties to invest in commercial paper, while at the same time increasing the importance of rating agency reviews in this process.

Mainsail issued commercial paper - short-term debt - to invest in higher-yielding, longer-dated assets consisting primarily of residential and commercial mortgage-backed securities. This type of commercial paper is known as asset-backed and accounts for approximately half of the commercial paper market. In July about a quarter of all asset-backed commercial paper had mortgages as collateral. Some of these mortgages were subprime loans. The term "subprime" refers to the credit status of the borrower (being less than ideal), not the interest rate on the loan itself.

A declining housing market, in combination with homeowners with poor credit histories or heavy debt loads, caused defaults to rise significantly, reaching almost 14 percent of U.S. subprime mortgages during the first quarter of 2007. This development prompted investors to avoid securities backed by mortgages and resulted in the market for these securities to evaporate. In addition, declines in this sector of the credit market led to reduced demand for corporate loans. The breakdown of the corporate commercial paper market became a crisis as banks confronted difficulty obtaining short term financing. With this volatility in the market, Mainsail was unable to roll over maturing commercial paper. The security trustee, the Bank of New York, now has control over this entity.

The conditions in the subprime mortgage market caused Moody's and S&P to downgrade Mainsail in August of this year.. S&P ratings went from A1+ to A-3 on August 21 and to B, short-term non-investment grade, on August 24. Moody's dropped the commercial paper rating from P-1 to "not prime", its short-term non-investment grade rating on August 22. These downgrades were part of massive downgrades of subprime mortgage-linked securities by the three rating agencies, including Fitch Ratings (Fitch). Investors have criticized the rating agencies both for their initial ratings on some of these securities and for failing to realize the situation sooner so as to downgrade subprime mortgage bonds after it became clear that defaults would surpass initial estimates. It is believed that these rating agency actions led to the elimination of liquidity in the commercial paper market by raising doubts about the ability of obligors to meet their obligations and the reliability of commercial paper ratings which have historically been essential to the orderly functioning of this market. The Securities and Exchange Commission has begun an investigation to determine whether the rating agencies followed proper procedures for rating mortgage-backed securities.

The market value of the collateral that backed Mainsail's paper and the manner in which the County eventually receives payment has not yet been determined. Mainsail has outstanding commercial paper obligations of $1.3 billion and at this time, none of the collateral has been liquidated. On September 6th, Barclays Capital, Britain's third largest bank that structured the Mainsail investment vehicle in 2006, proposed a restructuring to repay commercial paper holders in full; however, that proposal was not approved by its stakeholders. Also, the Secured Parties holding the majority of the Mainsail commercial paper have instructed the Bank of New York, the Security Trustee for the Mainsail commercial paper, not to make any distributions prior to a

certain date. That date has moved 4 times (Oct 1, Oct 22, Nov 16 and Dec 14). Although no time frame has been indicated for the final resolution of the Mainsail commercial paper, the most likely financing alternatives include:

1 – Restructuring the commercial paper to a longer maturity, potentially in the range of 2-4 years.
2 – Making interim distributions to the investors whenever principal and interest from the underlying securities are paid (although this could complicate efforts to restructure). At this point approximately $100 million is available.
3 - Selling the collateral and pay the investors with the proceeds. However, at this time, there is no market for these securities.

BALTIMORE COUNTY ACTIONS

While not all asset backed commercial paper has been downgraded by the rating agencies and subjected to liquidity problems, upon notification of the breach of the Mainsail commercial paper on August 27th, the County sold the remaining $40 million par value of commercial paper as a precaution. These securities were asset-backed but unrelated to the Mainsail commercial paper and the respective issuing entities have continued to be viable. The County currently holds no other direct investments of commercial paper and has no plans to purchase any commercial paper at this time. The County is currently investing in the highest rated U.S. government money market funds.

With resolution of the Mainsail distribution potentially as long as several years away, (assuming a restructuring to a security with a longer maturity), the County has discussed with its financial advisor, bond counsel and the rating agencies the transfer of the Mainsail commercial paper to the Police, Fire and Widows' (PFW) Pension Fund for the par value of $21.3 million. Taking into account the greater need for liquidity in the investment of funds held for general County purposes as compared to funds held to provide payment of more predictable long-term obligations,, the PFW Pension Fund is more suitable for holding securities over several years than the investment pool of current revenues that was used to purchase the commercial paper. The PFW Pension Fund was funded by the County in 1988 to provide to the County a source of funds to fund the payment of (theretofore) unfunded pension obligations to police officers and firefighters (and their surviving spouses) hired prior to October 1, 1959 who chose not to join the Employees' Retirement System of Baltimore County (Pension Obligations). At the time of the original funding of this account, the fund had assets of $170 million and after almost 20 years of operation still has assets totaling $129 million to support the remaining 392 retirees/beneficiaries. There were 704 retirees/beneficiaries and 25 active employees when the account was originally funded. Clearly, the fund has a long investment horizon in seeking to match the investments in the fund to predictable long-term Pension Obligations. The County

executed the transfer of the Mainsail commercial paper to the PFW Pension Fund on November 15, 2007 to greatly enhance the County's ability to realize the maximum value from the Mainsail security by positioning this investment in a fund with a longer investment horizon. .

It must be understood that the County's actions in no way jeopardize the pension beneficiaries. The County remains obligated under the Baltimore County Code to fully support the payment of the Pension Obligations. The amounts payable to the pension beneficiaries with respect to Pension Obligations are not impacted by the investment performance of the PFW Pension Fund. In addition, it should be noted that the funding of the PFW Fund remains sufficient to provide the County with a continuing source of funding to satisfy its obligations to the pension beneficiaries. According to the 11/1/07 valuation of the County's actuary, the PFW Pension Fund is over-funded by approximately $13.8 million or 12%. At this funding level, the PFW Pension Fund is fiscally healthy enough to support any potential revaluation of the Mainsail security.

As additional information becomes public regarding Merrill Lynch's active involvement in the creation of the subprime market, the County is reviewing whether Merrill Lynch properly discharged its obligations with regard to the accuracy of information provided to the County, and with regard to the notice of events occurring subsequent to the date of the County's purchase. The County no longer invests funds through Merrill Lynch and is exploring excluding Merrill Lynch from participation in sales of County bonds.

The County is prepared to submit a revised investment policy for County Council approval that is once again adopted from the Government Finance Officers Association's model investment policy. The County's revised policy, as before, will emphasize safety and diversification, but will also increase oversight through an investment committee and prohibit the purchase of asset-backed commercial paper and derivatives. The revised policy is designed to prevent a reoccurrence of another "Mainsail" situation.

As previously indicated, the County has notified the rating agencies of the commercial paper breach and of the sale to the PFW Pension Fund. All three rating agencies have indicated that this event will not affect the County's bond ratings. The rating agencies were pleased to hear that the County finished FY 2007 with an undesignated fund balance of $214 million, $30.8 million higher than projected in the FY 2008 budget submission. Most of the variance is attributable to a change in the State's Income Tax distribution ratios as illustrated below:

	FY 2007 Estimate	FY 2007 Final	Variance
General Fund Balance, June 30, 2006	$203.6	$203.6	$0.0
2007 Resources/ Revenues			
Property Taxes	659.8	663.3	3.5
Income Taxes	577.4	607.9	30.5
Service Taxes	167.8	170.6	2.8
Other Revenues	155.0	154.6	-.4
Less 2007 Expenditures	-1,597.5	-1,604.7	-7.2
General Fund Balance, June 30, 2007	166.1	$195.4	29.3
Less Amount Designated for FY2008	-59.0	-57.5	1.5
Less Required Transfer to Rev. Stabilization	-4.0	-4.0	0.0
Plus Revenue Stabilization Account	80.0	80.0	0.0
Amount Available FY08 Budget	$183.1	$213.9	$30.8

BUDGET UPDATE

In addition to finishing FY 2007 with a Fund Balance ahead of expectations, Baltimore County was able to end the year with a fully funded Employee Health Care Reserve Account. More importantly, the County ended FY 2007 with $156.3 million in the Other Post-Employment Benefits Account, enabling the County to meet its Annual Required Contribution for OPEB in FY 2008 – apparently the only jurisdiction in the State to do so. Moreover, within the operating budget the County was able to set aside $147 million of pay-go funds for the FY 2008 Capital Budget. (Another $56 million and $12 million have been programmed for FY 2009 and FY 2010, respectively). When considering the $147 million in pay-go funds, it should be noted that only $57.5 million of that allocation required a draw down of the County's Fund Balance. The remaining $89.5 million is tied to current ongoing revenues, thus giving the County great flexibility in funding the FY 2009 Operating Budget.

Along with a well-structured budget, preliminary estimates for FY 2008 indicate the County will finish ahead on revenues by $26 million ($9 million property taxes, $12 million income taxes, $5 million service taxes).

If you have any questions or would like to discuss this matter, please do not hesitate to contact me.

Sincerely,

Fred Homan
Administrative Officer

Attachment

c: The Honorable James. T. Smith, Jr.
The Honorable Kevin Kamenetz
The Honorable T. Bryan McIntire
The Honorable Kenneth N. Oliver
The Honorable Vincent J. Gardina
The Honorable Joseph Bartenfelder
The Honorable John Olszewski, Sr.
Thomas J. Peddicord, Jr., Legislative Counsel
Mary P. Allen, County Auditor
Keith Dorsey, Director, Office of Budget & Finance

July 31, 2007	Purchased Mainsail commercial paper due 8/24/07 from Merrill Lynch.
August 20, 2007	Mainsail breaches the terms of its structure concerning market value coverage, triggering a "wind down" event
August 21, 2007	S&P downgrades Mainsail commercial paper from A1+ to A-3.
August 22, 2007	Moody's dropped Mainsail commercial paper rating from P-1 to "not prime"
August 24, 2007	S&P downgrades Mainsail commercial paper from A-3 to B, short-term non investment grade
August 24, 2007	Mainsail fails to pay off its commercial paper at maturity
August 27, 2007	County notified of the Mainsail breach
August 27, 2007	County sold remaining commercial paper as precaution
August 29, 2007	County conducts conference calls with rating agencies
August 30, 2007	County sends letter requesting Merrill Lynch to repurchase Mainsail commercial paper
September 6, 2007	Barclays Capital proposes restructuring solution to Security Trustee that was regarded as credible
September 18, 2007	Merrill Lynch declines County's request to repurchase Mainsail commercial paper
September 21, 2007	Security trustee informed by Barclays that the proposal did not receive sufficient support from required stakeholders.
September 24, 2007	Security Trustee seeks directions from the Majority Secured Parties who direct the Trustee that no payments are to be made by the Trustee prior to October 1, 2007. The date was later extended to October 22.
September 27, 2007	Security Trustee engages financial adviser to evaluate the asset portfolio and assess strategic options.
October 17, 2007	After consulting with the Financial Adviser, the Security Trustee believes that an interim distribution of Available Funds may be prejudicial to the interests of the holders of Senior Obligations (holders of commercial paper obligations) as such a distribution may affect the implementation of any Refinancing Proposals. Security Trustee seeks direction from the Majority Secured Parties who direct the Trustee that no payments are to be made by the Trustee prior to November 16, 2007.
November 13, 2007	Security Trustee seeks direction from the Majority Secured Parties who direct the Trustee that no payments are to be made by the Trustee prior to December 14, 2007.